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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

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IN THE MATTER OF THE APPLICATION
OF THE ARIZONA ELECTRIC DIVISION OF
CITIZENS COMMUNICATIONS COMPANY
TO CHANGE THE CURRENT PURCHASED
POWER AND FUEL ADJUSTMENT CLAUSE
BANK, AND TO REQUEST APPROVED
GUIDELINES FOR THE RECOVERY OF
COSTS INCURRED IN CONNECTION WITH
ENERGY RISK MANAGEMENT ACTIVITIES

DOCKET NO. E-01032C-00-0751

IN THE MATTER OF THE APPLICATION OF
CITIZENS COMMUNICATIONS COMPANY,
ARIZONA GAS DIVISION, FOR A HEARING
TO DETERMINE THE FAIR VALUE OF ITS
PROPERTIES FOR RATEMAKING PURPOSES,
TO FIX A JUST AND REASONABLE RATE OF
RETURN THEREON, AND TO APPROVE RATE
SCHEDULES DESIGNED TO PROVIDE SUCH
RATE OF RETURN.

DOCKET NO. G-01032A-02-0598

IN THE MATTER OF THE APPLICATION OF
CITIZENS COMMUNICATIONS COMPANY
AND UNISOURCE ENERGY CORPORATION
FOR APPROVAL FOR THE SALE OF CERTAIN
ELECTRIC UTILITY AND GAS UTILITY
ASSETS IN ARIZONA, THE TRANSFER OF
CERTAIN CERTIFICATES OF CONVENIENCE
AND NECESSITY FROM CITIZENS COMMUN-
ICATIONS COMPANY TO UNISOURCE
ENERGY CORPORATION, THE APPROVAL
OF THE FINANCING FOR THE TRANS-
ACTIONS AND OTHER RELATED MATTERS.

DOCKET NO. E-01933A-02-0914
E-01032C-02-0914
G-01032A-02-0914

STAFF'S CLOSING BRIEF

Staff of the Utilities Division ("Staff") of the Arizona Corporation Commission
("Commission") hereby submits its Closing Brief regarding the above-captioned cases and the
Settlement Agreement. The Settlement Agreement resolves the matters pending in Docket Nos. G-
01032A-02-0598 ("Gas Rate Case"), E-01032C-00-0751 ("PPFAC Case"), and E-01933A-02-0914,
E-01302C-02-0914, G-01302C-02-0914 ("Joint Application") (collectively, the "Consolidated
Cases") and allows for the purchase by UniSource Energy Corporation ("UniSource") of Arizona gas

1 and electric utility assets currently owned by Citizens Communications Company ("Citizens").

2 I. INTRODUCTION.

3 The key determinant for the Commission in this case is to find whether the Settlement
4 Agreement, admitted as Exhibit JA-6, is in the public interest. To determine whether the public
5 interest is met by the Settlement Agreement, one only needs to compare the status of the many issues
6 in the above-captioned cases prior to the filing of the Joint Application and the Settlement
7 Agreement, and the subsequent resolution of those many issues in the Settlement Agreement.
8 Viewing the issues with the Settlement Agreement, it is clear to see how better served the public
9 interest is with the Settlement Agreement than without it.

10 The Settlement Agreement resolves a myriad of issues to maximize the public benefit and
11 minimize the impacts to the public. The Settlement Agreement maximizes the public benefit through
12 the following:

- 13 • Elimination of the entire under-recovered balance in the Purchased Power Fuel
14 Adjustor Clause ("PPFAC"), estimated to be at least \$135 million as of July 28,
15 2003¹.
- 16 • A provision to ensure that electric ratepayers receive sixty percent of any savings that
17 result from any successful renegotiation of the purchased power contract with
18 Pinnacle West Capital Corporation ("PWCC").
- 19 • A requirement to file a plan to introduce retail electric competition in the new electric
20 company's service territories by December 31, 2004.
- 21 • A permanent reduction of over \$93 million in electric rate base to be applied in future
22 rate cases.
- 23 • A mandatory requirement to explore opportunities for operational consolidation and
24 coordination between the new electric company's ("ElecCo's") operations in Santa
25 Cruz County and Tucson Electric Power Company ("TEP").
- 26 • Joint participation by ElecCo and TEP in the Environmental Portfolio Standard
27 ("EPS").
- 28 • A permanent reduction of over \$40 million in gas rate base that will apply in the
present, as well as future, gas rate cases, including a \$10 million permanent write-
down of plant attributable to Staff's review of the Buildout program.
- A reduction of gas revenue requirements from approximately \$21.0 million to
approximately \$15.1 million, or a reduction of eight percent from Citizen's original
filing.

¹ This number does not include the carrying costs that were requested by Citizens in the original proceeding. That amount is estimated to be approximately \$18 to \$19 million (See Ex. S-1 at 38). Since the under-recovered balance will not be recovered from electric customers, those customers will be spared from exposure to paying carrying costs on that balance. This means further savings are achieved for electric customers.

- 1 • A gas rate design that minimizes the increase in the residential customer service charge.
- 2 • Seven pipeline safety provisions to ensure continued reliable and safe gas operations.
- 3 • Three-year moratoriums from filing for base rate increases for both gas and electric services.
- 4 • Financing provisions to provide protection, insurance and benefits to TEP and TEP
- 5 ratepayers for the \$50 million loan from TEP to UniSource ("TEP Loan"), if this
- 6 mechanism is utilized as part of the overall financing of the transaction.
- 7 • Dividend restrictions to best ensure that all regulated utility assets owned by
- 8 UniSource will be financially healthy entities.

8 Without the Settlement Agreement, gas and electric customers would likely be facing
9 significantly higher rate increases. The record shows that the Settlement Agreement maximizes the
10 public benefit both in the immediate-term and in the long-term, minimizes the impacts and was the
11 result of an open and fair process giving ample opportunity for parties to participate. Viewed as an
12 integrated whole, the Settlement Agreement clearly is in the public interest.

13 **II. BACKGROUND.**

14 The Settlement Agreement, if approved by the Commission, will allow for the acquisition of
15 Citizens gas and electric utility assets by UniSource. UniSource is an Arizona corporation and the
16 holding company for TEP. If the Settlement Agreement is approved by the Commission, UniSource
17 has indicated that it will form two new separate companies to provide gas and electric service
18 (referred to in the Joint Application and the Settlement Agreement as "GasCo" and "ElecCo"
19 respectively, and are collectively referred to as the "New Companies"). The acquisition by
20 UniSource of Citizens' gas and electric assets is dependent upon successful settlement of the
21 Consolidated Cases. This Agreement allows UniSource to purchase those assets while minimizing
22 impacts to electric and gas customers.

23 It is vitally important to UniSource to have all three cases resolved expeditiously, such that it
24 can proceed with the acquisition of Citizens' gas and electric assets. (T. at 74-76). The Joint
25 Application seeking resolution of the Consolidated Cases was filed on December 18, 2002. Formal
26 consolidation of the cases occurred per the Procedural Conference on January 17, 2003. The
27 Procedural Order of February 10, 2003, outlined the process, including the due date for filing the
28 Settlement Agreement. The settlement process was designed with an awareness of UniSource's need

1 to have an expeditious process in place, but still provided ample notice and opportunity for all parties
2 to participate and comment. Despite the short timeframe, Staff worked arduously to ensure that the
3 Settlement Agreement represented a comprehensive resolution of the Consolidated Cases, which
4 fully maximized the benefit to the public and minimized any impacts. As will be discussed below,
5 the Settlement process was open and inclusive of all the intervenors in this case.

6 **III. THE SETTLEMENT AGREEMENT RESULTS IN A NEW PPFAC ADJUSTOR**
7 **RATE THAT MINIMIZES THE INCREASE TO ELECTRIC CUSTOMERS**
8 **WHILE PROVIDING SIGNIFICANT AND SUBSTANTIAL BENEFITS.**

9 The Joint Application indicated that UniSource was “willing to forego the PPFAC balance in
10 existence at the time of closing [of the sale and transfer of the gas and electric utility assets]. . . ”
11 (See Joint Application at 3). The Settlement Agreement memorializes that UniSource and Citizens
12 will forgo the right to pursue any of the amount in the under-recovered balance from the PPFAC
13 through the date of closing of the sale and transfer of gas and electric utility assets by Citizens to
14 UniSource (“date of closing”). (Ex. JA-6 at 15, ¶ 27). In other words, the entire under-recovered
15 balance will be eliminated through the date of closing. Prior to the Joint Application and Settlement
16 Agreement, the original PPFAC proceeding was a contentious and controversial docket with a
17 procedural history that can only be described as unique. As is highlighted below, the Settlement
18 Agreement eradicates that dispute as well as providing for substantial long-term benefits for electric
19 customers.

20 **A. The Under-Recovered Amount in the PPFAC Balance.**

21 Much of the contention in the original proceeding involving the PPFAC (“original
22 proceeding”) was regarding the \$87 million portion of the under-recovered balance due to what is
23 commonly referred to as the ‘Old Contract’². The dispute between APS and Citizens over the
24 interpretation of the Old Contract was one of the main reasons for Staff’s recommendation of a
25 deferral of costs in the original proceeding³. (Ex. S-1 at 34-35, 36-37). In the Settlement Agreement,

26 ² This is the purchased power contract between Citizens and Arizona Public Service Company (“APS”) where APS
27 would supply Citizens with virtually all of its power for Citizens to serve its load. This contract was effective from
1995 to June 1, 2001.

28 ³ In the original proceeding, Staff had recommended that \$70 million out of the \$87 million then at issue be deferred
pending resolution of the dispute between APS and Citizens over interpretation of the Old Contract before the
Federal Energy Regulatory Commission (“FERC”). (Ex. S-1 at 36-37). Staff had also recommended an automatic
disallowance of \$7 million. (Ex. S-1 at 36-37).

1 the entire amount of under-recovered balance pertaining to the Old Contract will never be recovered
2 from retail ratepayers. (T. at 296).

3 Similarly, the under-recovered balance attributable to what is known as the 'New Contract',
4 which is estimated to be at least \$48 million by July 28, 2003, will also never be recovered from
5 retail ratepayers. (T. at 296). The New Contract supplanted the Old Contract and is the current
6 agreement between Citizens and PWCC for purchased power effective June 1, 2001. Under the New
7 Contract, power is supplied by PWCC and delivered to Citizens, for a total charge of \$0.07019 per
8 kilowatt hour ("kWh"). Of that \$0.07019 per kWh, the component attributable to generation supply
9 under the New Contract equals \$0.05879 per kWh. However, by UniSource and Citizens forgoing
10 the right to recover the entire under-recovered balance, the New Contract becomes a prospective
11 contract from the date of closing. Consequently, electric retail ratepayers will not be paying any of
12 the amount in the under-recovered balance due to the New Contract. This means that electric
13 customers will only pay base electric rates for the first two years plus of the New Contract, and are
14 currently paying less for power than the actual cost of that power. (T. at 298, 301).

15 In sum, electric customers will be spared from paying a significant sum of money, whatever
16 the ultimate outcome would have been before the Commission in the original proceeding. As
17 explained in the Staff Report, the outcome under the Settlement Agreement betters even the best-
18 case outcome advocated by Staff in the original proceeding. (Ex. S-1 at 40-42). Given the uncertain
19 finality that existed in the PPFAC Case, it is very possible that electric customers would have been
20 exposed to the entire amount of the under-recovered balance, estimated to be at least \$135 million by
21 July 28, 2003⁴. Under the Settlement Agreement, retail ratepayers are permanently spared from any
22 such exposure. The Settlement Agreement provides a concrete and immediate benefit with this
23 complete elimination that cannot be achieved without it. The Settlement Agreement resolves the
24 above-described issues and gives finality to these contentious disputes.

25
26
27 ⁴It is unclear what the ultimate outcome at FERC would be regarding the dispute between APS and Citizens over
28 interpretation of the Old Contract. It would be very possible that the FERC could have ruled such that the \$70
million out of the \$87 million at issue would be recoverable from retail ratepayers. Furthermore, even the \$7 million
out of the \$87 million at issue that Staff recommended be automatically disallowed could have been subject to
further litigation. Any disallowance of the amount in the under-recovered balance attributable to the New Contract
could also have been subject to further litigation. The Settlement Agreement eliminates those uncertainties.

1 **B. The price for power in the New Contract is reasonable on a going-forward**
2 **basis.**

3 As discussed above, the under-recovered balance of costs attributable to the New Contract
4 through the date of closing will not be recovered by electric customers of ElecCo. The current
5 customers of Citizens Arizona Electric Division ("AED") will become the customers of ElecCo.
6 These electric customers will only have been paying base electric rates from June 1, 2001, through
7 the date of closing, currently anticipated to be July 28, 2003⁵. The New Contract essentially becomes
8 a five-year contract effective from the date of closing. (Ex. S-1 at 37-38). Therefore, to determine
9 the reasonableness of the New Contract, one only needs to compare the price in the New Contract on
10 a going forward basis. (T. at 301).

11 The new adjustor rate being proposed in the Settlement Agreement reflects the purchased
12 power cost under the New Contract on a going forward basis. In other words, the adjustor rate
13 increase to \$0.01825 per kWh from \$0.0000 per kWh accommodates the total cost of purchased
14 power and the total cost of transmission, totaling \$0.07019 per kWh under the New Contract⁶. The
15 New Contract was approved by FERC. Two additional items should be noted at this point. One is
16 that the PPFAC case has never been about an adjustment to base electric rates; base rates will remain
17 the same until the next rate case. The other item is that since none of the under-recovered balance
18 will be assessed against ratepayers, the proposed adjustor rate in the Settlement Agreement is *solely*
19 to ensure full recovery for the cost of purchased power and the cost of transmission under the New
20 Contract on a going-forward basis⁷.

21
22 ⁵ The Commission last approved an adjustment in the AED base rates in Decision No. 59951. The total cost for
23 purchased power established in that base rate case equals \$0.05194 per kWh. (See Decision No. 59951 at 15). That
24 cost is comprised of the base cost of electric generation of \$0.04802 as well as a transmission component of
25 \$0.00392. (Ex. JA-6, Appendix C). Essentially, from June 1, 2001 to the date of closing, electric customers will pay
26 approximately 4.8 cents per kWh for electric generation priced at 5.8 cents per kWh.

27 ⁶ During the evidentiary hearing, the figure of \$0.05879 per kWh to describe the 'price' in the New Contract was
28 frequently used. This is the cost of generation supply, as a component of the total cost of purchased power, in the
New Contract (Ex. S-1 at 33, 35; T. at 440). The total cost of \$0.07019 per kWh is determined taking the cost of
generation and delivery (\$0.05879 per kWh), factoring in the line loss component ($\$0.05879/[1-10.69\%]$ or
\$0.06583) and adding in the transmission component (\$0.00436 per kWh). (See Ex. JA-6, Appendix C). However,
the \$0.05879 per kWh figure is the price to be used to compare to market prices for generation plus the appropriate
factors to be added to those market prices to represent load-following long-term supply.

⁷ The New Contract, because of FERC approval, market volatility and high prices, would have been difficult to
challenge as being unreasonable. It is unlikely that the New Contract would be determined to be unreasonable or
inappropriate as of June 1, 2001 by FERC. (Ex. S-1 at 37). The Settlement Agreement disallows under-recovered
amounts of \$48 million plus attributable to the New Contract and likely recoverable regardless of the outcome with

Staff concluded that the price for purchased power under the New Contract is reasonable on a going forward basis. (Ex. S-1 at 38). Even the Residential Utility Consumer Office ("RUCO") indicates that the New Contract is reasonable going-forward and that the proposed adjustor rate is "cost-based." (T. at 549, 576). Ms. Lee Smith, the Consultant for Staff, went into great detail during the evidentiary hearing about the reasonableness of the purchased power price in the New Contract. Ms. Smith summarized the many factors that need to be considered when comparing contract prices to known market prices for blocks of power, for reasonableness as follows:

- Acquiring power to follow load.
- Long-distance transmission
- Ancillary Services
- Risk premium due to the length of the contract.

(T. at 301-03).

Reviewing the spot prices available from Palo Verde, Ms. Smith concluded that the price of purchased power in the New Contract is reasonable, factoring in all the appropriate adders, when compared to the market. (T. at 303-04). Finally, even if market manipulation was one of many factors that created an expectation of higher prices in 2001, the relevant comparison to make is reasonableness of the price in the New Contract compared to market prices with the appropriate adders on a going forward basis. (T. at 306-08). In other words, any market manipulation which may have played a role in the agreed-upon price is independent of and irrelevant to the comparison that should be done on a prospective basis⁸. Based on the appropriate analysis conducted by Staff, the price in the New Contract is reasonable on a going-forward basis. (T. at 308).

C. **The Settlement Agreement includes significant benefits for electric customers not envisioned in the original proceeding.**

One of the big benefits to the Settlement Agreement is the introduction of retail electric

the Old Contract.

⁸ As discussed at the evidentiary hearing, it is highly unlikely that market manipulation was the chief contributor to the purchased power price in the New Contract anyway, since a bulk of the manipulation was exclusive to California and since there were a multitude of factors that contributed to the increased price for purchased power. (T. at 306-07). Ms. Smith described several other factors contributing to higher prices in 2001 that were independent of any market manipulation, including hot weather, low hydro, inadequate supplies and inadequate transmission in California. (T. at 306).

1 competition in the service territories in Mohave and Santa Cruz Counties by no later than December
2 31, 2004. (Ex. JA-6 at 8-9, ¶ 11). Ms. Lee Smith for Staff explained how this provision will likely
3 lead to a successful competitive environment due to the sizable “credit” to electric customer’s bills
4 once competition is introduced. (T. at 299, 346-47, 440). Furthermore, stranded costs due to
5 generation, as a result of this Settlement Agreement, are determined to be zero. (Ex. JA-6 at 9, ¶ 12;
6 Ex. S-1 at 43-44). The Settlement Agreement provides for this long-term benefit that was not even
7 part of the equation during the original PPFAC proceeding.

8 The 60/40 “sharing” provision in the Settlement Agreement was the topic of much
9 discussion. The Settlement Agreement provides that if the price for purchased power under the New
10 Contract is renegotiated to a lower price, sixty percent of the savings will go to the retail ratepayers
11 and forty percent will go to UniSource. (Ex. JA-6 at 15-16, ¶ 28). Because all the evidence presented
12 and admitted in the evidentiary hearing points to the reasonableness of the price in the New Contract,
13 UniSource has no mandatory obligation to renegotiate that price. This provision in the Settlement
14 Agreement provides incentive for UniSource to renegotiate with PWCC and compensation for the
15 cost of the renegotiation effort, while giving the retail ratepayers the majority of the savings⁹. (T. at
16 349). Staff believes, given the above, the proportional sharing is appropriate in light of all the other
17 immense benefits achieved in the Settlement Agreement. (T. at 330, 349). While UniSource may
18 benefit from a lower contract price for purchased power, renegotiation will provide benefits to all
19 retail ratepayers.

20 Another long-term benefit to electric customers is the reduction in electric rate base due to
21 the negative acquisition adjustment of over \$93 million. The Settlement Agreement ensures that the
22 accounting of this adjustment will be such that electric customers will see this benefit in future
23 electric rate cases. (Ex. JA-6 at 17-18, ¶ 35). Combined with the corresponding reduction in
24 depreciation expense, this provision is estimated to result in a \$15 million annual reduction in the
25 revenue requirement in future base electric rate cases. (Ex. S-1 at 43). This is a significant long-term
26

27 ⁹While some parties may argue this violates the “pass through” principle for adjustors, since UniSource would
28 already be passing through a reasonable cost for purchased power, any renegotiation to a lower price is an added
bonus to ratepayers of ElecCo, even with the 60/40 sharing of the savings between ratepayers and shareholders. As
to what incentive PWCC may have to renegotiate the price of purchased power in the New Contract, the introduction
of retail electric competition by December 31, 2004 might be that incentive for PWCC to renegotiate. (T. at 347-48).

benefit provided for in the Settlement Agreement.

Furthermore, the Settlement Agreement mandates exploration by UniSource towards achieving operational consolidation and/or coordination between the Santa Cruz operations and TEP at the time of TEP's next general rate filing. (Ex. JA-6 at 9, ¶ 13). TEP's next rate filing is expected to be in June of 2004 per Commission Decision No. 62103. Ms. Smith testified that this provision could lead to real benefits for Santa Cruz electric customers, such as improved reliability and economies of scale. (Ex. S-1 at 43; T. at 393-94). This long-term benefit was not envisioned in the original PPFAC proceeding, nor could such consolidation/coordination occur with TEP without UniSource acquiring the electric assets. Santa Cruz electric customers stand to gain further benefit in the long-term via this provision in the Settlement Agreement.

All of the above provisions, plus the three-year moratorium before a base electric rate case can be filed, maximize the benefit to electric customers and minimize the increase to the adjustor rate. ElecCo's customers will only be responsible for the full price of purchased power under the New Contract prospectively and the adjustor rate for the PPFAC will only reflect the costs for purchased power under the New Contract going-forward from the date of closing. The Settlement Agreement spares these customers from potential liability for the mammoth amount in the under-recovered balance, and puts mechanisms in place to secure further benefits into the future. But for the Settlement Agreement, the magnitude and certainty of such benefits would not be obtainable.

IV. THE SETTLEMENT AGREEMENT MITIGATES THE RATE INCREASE AND CONSOLIDATES RATES WITH MAXIMUM BENEFIT TO GAS CUSTOMERS.

The Settlement Agreement provides substantial benefit to gas ratepayers in the form of a significant reduction to gas rate base. This reduction is accomplished in two ways. One is the negative acquisition adjustment of \$30.7 million that will be a reduction to rate base in this and future gas rate filings. (Ex. JA-6 at 17-18, ¶ 35). This adjustment is the same type of adjustment that will be made in future electric rate filings described above. Furthermore, Staff negotiated an additional \$10 million reduction in gas rate base due to its review of the Buildout Program. (Ex. JA-6 at 18, ¶ 36(b))¹⁰. These two reductions, combined with a corresponding reduction in depreciation

¹⁰ The Buildout Program was originally approved by the Commission in Decision No. 58664. Its purpose was to extend gas service to areas within Citizens service territory to additional customers, where economically feasible.

1 expense, will cut the gas rate revenue requirements from approximately \$21.0 million to about \$15.1
2 million, or a reduction in the increase by roughly eight percent. (Ex. JA-6, Appendix B, Schedule 1).

3 The Settlement Agreement results in a reduction of gas rate base of over \$40 million. Staff
4 believes that the reduction in rate base due to the negative acquisition adjustment in the Joint
5 Application should be attributable to Staff's review of the Buildout Program. (Ex. S-1 at 18-19). The
6 review of the Buildout Program was to be, by far, the main issue in any stand-alone gas rate
7 proceeding and is the predominant reason underlying Citizens' and UniSource's request for a
8 significant increase in base rates at this point in time. (Ex. S-1 at 26; T. at 290). Staff notes that
9 many of the other issues that had existed in past gas rate filings by Citizens did not exist either in the
10 original gas rate filing of August, 2002 or in the Joint Application by UniSource¹¹. (Ex. S-1 at 10-12,
11 26; T. at 290). The negative acquisition adjustment for gas rate base, combined with the additional
12 \$10 million permanent write-down of plant, results in a significant savings unlikely to be achieved
13 without the Settlement Agreement. (Ex. S-1 at 22). In short, it is highly doubtful that a full rate
14 hearing would approach the amount of rate base disallowance and the reduction of the revenue
15 requirement in the Settlement Agreement. (T. at 293-94).

16 The proposed gas rate consolidation in the Settlement Agreement also serves to significantly
17 benefit gas customers in Santa Cruz County while minimally affecting gas customers in Northern
18 Arizona. Mr. James Dittmer, the Staff Witness on gas rate issues, testified during the evidentiary
19 hearing that Santa Cruz gas customers would likely be facing a rate increase approaching thirty
20 percent without consolidation (T. at 360-61). Since there are far more gas customers in Northern
21 Arizona than in Santa Cruz County, the corresponding impact to gas customers in Northern Arizona
22 is less than one percent. (T. at 360-61). Mr. Dittmer further explained that the benefits of
23 consolidation override the arguments against consolidation. (T. at 434-35). Furthermore, even though
24 the Buildout Program was for areas in Northern Arizona, the decrease in rate base of over \$40
25 million with the corresponding decrease in depreciation expense will benefit Santa Cruz gas
26

27 (Ex. S-1 at 13). As noted in the Staff Report, the actual cost and timeframe to complete the Buildout Program
exceeded what was originally envisioned. (Ex. S-1 at 14-15).

28 ¹¹ Regarding cost of capital, the rate of return in the Settlement Agreement includes Staff's analysis of cost of equity.
(Ex. S-2). As detailed in the Staff Report, from a revenue requirements perspective, gas ratepayers are slightly better
off with UniSource ownership than Citizens ownership. (Ex. S-1 at 24-26).

1 customers in addition to Northern Arizona gas customers. (T. at 360). The residential customer
2 service charge under the Settlement Agreement only increases to \$7.00 per month, as opposed to
3 \$10.00 per month originally requested. (Ex. JA-6, Appendix B, Schedule 3; Ex. S-1 at 27-28).
4 Combining the benefits explained above with a three-year moratorium on a base gas rate filing as
5 well as seven pipeline safety conditions, it is clear that gas customers receive a maximum benefit
6 from this Settlement Agreement that would unlikely be obtainable otherwise.

7
8 **V. FINANCING AND CAPITAL STRUCTURE PROVISIONS IN THE SETTLEMENT**
9 **AGREEMENT INSULATE RATEPAYERS FROM HARM AND PROVIDE**
10 **FURTHER BENEFITS.**

11 UniSource has always cited the need for flexibility in financing this transaction. (Ex. JA-7 at
12 2; T. at 132). Flexibility is needed to finance this transaction in a timely fashion and with the lowest
13 cost, to best ensure that the New Companies being established to serve gas and electric customers
14 will have investment grade status. (T. at 149). Staff understands and accepts UniSource's need for
15 flexibility in order to timely complete the transaction. However, Staff has concerns with the
16 financing, particularly with the \$50 million loan from TEP to UniSource ("TEP loan") proposed as
17 an option in the financing proposal. Included in the Settlement Agreement are provisions designed
18 to insulate TEP customers from harm, as well as to provide benefits to those customers. Staff
19 believes those provisions successfully address its concerns over the TEP loan.

20 The major difference between the TEP loan in this case versus loans by regulated utilities that
21 were the subject of recent hearings before the FERC and this Commission is that this TEP loan is
22 being used to fund the acquisition of regulated utility assets. (Ex. JA-8 at 4; Ex. S-1 at 46-47; T. at
23 314). Staff believes the TEP loan is for utility purposes, which distinguishes this case from the
24 FERC holding in Docket No. ES02-51-000. (See 102 FERC ¶ 61,186). This case is also
25 distinguishable from the recent APS Financing case, which involved approval of a \$500 million loan
26 from APS in order to aid a non Commission-regulated entity. (See Decision No. 65796 at 5). In
27 short, the TEP loan, because of its purpose, can be justified in principal.

28 However, provisions are in the Settlement Agreement to make the TEP loan a benefit to TEP
customers, to assuage the concerns and to ameliorate the security surrounding this aspect of the

1 financing. The Settlement Agreement includes interest income provisions such that a certain
2 proportion of the interest will be used to offset future rate increases. (Ex. JA-6 at 11, ¶ 16(c)(1)).
3 That amount is estimated to be approximately \$6 million. (T. at 314). The remaining interest income
4 will be used to further boost TEP's improving equity capitalization. (Ex. JA-6 at 11, ¶ 16(c)(2)). A
5 "hold harmless" provision has also been included to ensure that TEP's customers are not hurt from
6 this loan. (Ex. JA-6 at 11, ¶ 16(d)). While a guarantee, rather than the TEP loan, is certainly another
7 means by which this transaction could be financed, the provisions in the Settlement Agreement
8 provide direct and indirect benefits to TEP ratepayers unlikely to be obtained with a guarantee.
9 Additionally, should UniSource not fulfill its obligations to pay back the TEP loan, TEP would
10 assume control of the New Companies via controlling all of the equity associated with the New
11 Companies. (Ex. JA-6 at 10-11, ¶ 16(a)). Given that TEP will be able to perform and fund its
12 mandatory operations and maintenance tasks and be able to continue to contribute funds towards
13 continuing to build its equity capitalization, Staff believes that despite the uneasiness with the TEP
14 loan, enough insulation, protection and benefit has been provided in the Settlement Agreement to
15 make the risk acceptable.

16 Given UniSource's need for flexibility, the capital structure provisions in the Settlement
17 Agreement balance the need for flexibility with the need to ensure financially healthy utilities. (Ex.
18 JA-6 at 12-13, ¶ 19, 20). The provisions in the Settlement Agreement addressing this area were
19 designed from the condition establishing UniSource as a holding company for TEP (See Decision
20 No. 60480 at 17, Attachment A, ¶ 20). Since the condition in Decision No. 60480 has contributed to
21 TEP's improving capital structure, Staff believes the same types of conditions are appropriate and
22 will be successful for TEP and the New Companies. (Ex. S-1 at 46). As explained during the
23 evidentiary hearing, having the right mix of debt and equity capitalization will ensure lower costs of
24 capital. (T. at 148-49, 316). Forty percent equity capitalization is an appropriate benchmark for a
25 healthy mix of debt and equity for TEP and the New Companies. (Ex. S-1 at 46; T. at 316). For those
26 reasons, Staff believes that the capital structure provisions will best ensure that TEP *and* the New
27 Companies will achieve and maintain financial health to the benefit of electric and gas customers¹².

28
¹² Specifically with regards to TEP, the interest income provisions cited above will work harmoniously with the capital structure provisions to accelerate the achievement of forty percent equity capitalization for TEP.

1 Certainly, the financing of such a significant transaction which affects many thousands of
2 ratepayers should always be of concern¹³. However, the Settlement Agreement includes financing
3 and capital structure provisions designed to insulate ratepayers from harm and allow for the right
4 combination of financing methodologies to provide maximum benefits to ratepayers in the form of
5 lower costs of capital. The Settlement Agreement has several provisions specifically targeting the
6 TEP loan and ensuring that TEP customers will not be adversely affected. Given the immense
7 benefits achieved for both electric and gas customers and with the financing provisions in the
8 Settlement Agreement, Staff believes the public interest is ensured.

9
10 **VI. THE FRANCHISE PROVISIONS IN THE SETTLEMENT AGREEMENT ARE APPROPRIATE.**

11 The Settlement Agreement requires UniSource to file copies of the franchises for both the
12 new gas and electric company with the Commission within 365 days of Commission approval of the
13 Settlement Agreement, should the Commission approve the Settlement Agreement. (Ex. JA-6 at 7-8,
14 ¶ 8, 9). The franchise provisions are typical of what Staff has recommended when Certificates of
15 Convenience and Necessity ("CC&Ns") are transferred from one public service corporation to
16 another. (T. at 354). These provisions allow time for the franchise issue to be worked out between
17 UniSource and the appropriate municipalities and governmental entities. This provision also allows
18 the Commission sufficient latitude to determine what remedies are appropriate should the franchise
19 not be obtained. The Commission does not need to bind itself to a particular remedy if an issue were
20 to come up regarding UniSource obtaining the franchise agreements. Staff believes the Commission
21 should not relinquish its discretion to determine the appropriate course of action here. While the
22 City of Nogales refers to Docket No. E-01032B-98-062 in support for a penalty provision if a
23 franchise is not obtained, the Commission did not include a penalty provision in the final decision
24 arising from that docket. (See Decision No. 61793)¹⁴. Furthermore, UniSource was not a party to that

25
26 ¹³The amount of debt was another concern raised about the financing during the evidentiary hearing. Staff believes
27 the New Companies will have the cash flow needed to pay off the debts and equity infusions being utilized to finance
28 the acquisition. (T. at 444). Staff understands that the permanent financing of up to \$175 million is not cumulative
with the \$250 million bridge financing cited in the Joint Application. Staff understands the maximum financing via
debt issuances from the New Companies would not exceed \$250 million. Staff anticipates a late-filed exhibit will be
submitted showing that the cash flows of the New Companies will be sufficient to cover the debt issuances, as well as
the TEP loan.

¹⁴ That decision approved a settlement agreement between Citizens and the City of Nogales. The agreement in that

1 docket, so it is questionable at best what relevance that docket has to this proceeding and the
2 Settlement Agreement. The City of Nogales has offered no evidence justifying the need to modify
3 the franchise provisions in the Settlement Agreement, and Staff believes that such modifications,
4 alluded to by the City of Nogales during the evidentiary hearing, are premature.

5 **VII. THE PROCESS CONDUCTED BY STAFF WAS FAIR AND INCLUSIVE.**

6 It is unfortunate that certain parties have chosen to attack Staff and attack the process *ex post*
7 *facto* that produced the Settlement Agreement, rather than focusing on the substance of the
8 Settlement Agreement. This attack is both unfair and unwarranted. As described in the Staff Report
9 and in the evidentiary hearing, Staff went to great lengths to ensure that the process was inclusive.
10 (Ex. S-1 at 1-2; T. at 379-80). This included three status meetings in January to ensure that all the
11 issues of concern to any intervenor were discussed. The process also included one status meeting on
12 March 31, 2003, to discuss the Settlement Agreement reached between Staff and the Joint
13 Applicants. These status meetings were held in addition to the formal process outlined in the
14 Procedural Order of February 10, 2003, which gave all intervenors ample notice and opportunity to
15 comment on any settlement reached.

16 Staff also explained why it decided to negotiate independently with UniSource after the first
17 three status meetings. As explained both in the Staff Report and during the evidentiary hearing, it
18 would have been highly improbable, given the sheer number of persons, issues and viewpoints, to be
19 able to successfully negotiate any settlement without meeting one on one with the Joint Applicants.
20 (Ex. S-1 at 1-2; T. at 379-80). Staff encouraged the intervenors to meet independently with the Joint
21 Applicants as well. (T. at 380). Mr. Steve Glaser, the principal negotiator for UniSource, testified
22 that UniSource did meet independently with all intervenors while the negotiations with Staff were
23 ongoing. (T. at 125-26). Neither before the negotiations commenced, nor during the time period that
24 Staff met independently with the Joint Applicants, did any intervenor object to the process. (T. at
25 142-43, 287). No party ever filed a pleading complaining about Staff independently meeting with
26 the Joint Applicants to negotiate a settlement. It is clear from the evidentiary record that Staff went
27

28 case stated that both parties will "work together to negotiate a mutually acceptable 25-year franchise to submit to
City voters for their approval." (See Decision No. 61973, Attachment Entitled "Revised Settlement Agreement
Between City of Nogales, Arizona, and Citizens Utilities Company" at 7).

1 above and beyond the legal requirements of procedural due process to ensure that all parties would
2 be included in the process, in addition to the opportunities provided in the Procedural Order. For
3 some parties to wait until the last minute to criticize the process *ex post facto* is simply unfair.

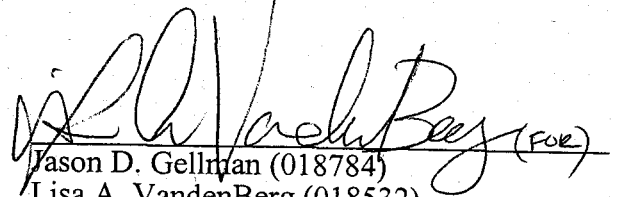
4 The Settlement Agreement does attempt to satisfactorily address many, if not all, of the issues
5 raised by the intervenors in the status meetings. Certainly, Staff tried to best accommodate the
6 concerns of all the parties in the Settlement Agreement, within the confines of the realities and
7 limitations that exist. Staff also understands that even with all of the attributes of the Settlement
8 Agreement, legitimate concerns do exist about the rate increases that are included in the Settlement
9 Agreement. Staff was never intending to browbeat the other parties into blind support of the
10 Settlement Agreement, if any party had some trepidation over its contents. The other parties still
11 have opportunity to indicate what parts of the Settlement Agreement they support, what they believe
12 are the problems in the Settlement Agreement, and/or what recommendations they believe would
13 improve the Settlement Agreement before this Commission. However, Staff cannot decipher the
14 unconscious workings of all other parties, nor can it simply negotiate for one portion of the overall
15 public interest. Staff negotiated with the goal of achieving the maximum overall public benefit while
16 minimizing the impacts, and Staff believes that goal was achieved with the Settlement Agreement.
17 While it is within every other party's right to disagree with the substance of the achievement, the
18 last-minute attacks on the process are without justification.

19 **VIII. CONCLUSION.**

20 Staff stressed in its opening statement that the Settlement Agreement needs to be looked as an
21 integrated whole. (T. at 37-38). By looking at this Settlement Agreement as an integrated whole, the
22 evidence is clear that the Settlement Agreement puts the electric and gas customers in substantially
23 better position than without the Joint Application and the Settlement Agreement. While Staff
24 understands that the rate increases are nothing to scoff at, the entirety of the Settlement Agreement
25 provides an abundance of benefits and a minimization of impacts. The Settlement Agreement
26 permanently eliminates the electric customer's exposure to a mammoth amount in the under-
27 recovered balance associated with the PPFAC. The Settlement Agreement provides many significant
28 long-term benefits to electric customers likely not achievable without the Settlement Agreement.

1 The Settlement Agreement minimizes the increase to gas customers, consolidates rates to the
2 advantage of Santa Cruz gas customers, and continually ensures safety in gas operations and
3 maintenance. The Settlement Agreement ensures reductions in rate base will apply in future electric
4 and gas rate cases. The Settlement Agreement provides financing and capital structure provisions to
5 best ensure the financial health of all regulated utilities owned by UniSource, ensuring protections
6 and providing additional benefits. The Settlement Agreement is fair and the process by which the
7 Settlement Agreement was reached was fair. Staff believes that the Settlement Agreement is in the
8 public interest and respectfully requests approval.

9
10 RESPECTFULLY SUBMITTED this 15th day of May, 2003.

11
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